Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-7173-98
LDBrigman

date: JUN 26 2000

to: Chief, Examination Division, Houston District
Ronald W. Moseley, International Examiner, Group 1406

from: District Counsel, Houston District, Houston

---

subject: [redacted]

You requested our opinion of whether there is a sound basis to disallow a worthless stock deduction in the amount of $[redacted] taken by [redacted] on their [redacted] income tax return. The facts are listed below in chronological order.

Your request did not cover the possible application of I.R.C. § 367(b). Inbound asset reorganizations and inbound § 332 liquidations can trigger the income taxation at the shareholder level of previously deferred earnings and profits. Further, we do not know whether [redacted] complied with I.R.C. § 367(a) and reported any "super royalties" in connection with its transfer of "other" intangibles (e.g., the license for the [redacted] company to use the [redacted] logo and name.).

Issues Raised

1. Whether [redacted] sustained a worthless stock loss in the amount of $[redacted] during taxable year [redacted] for its investment in [redacted]?

a. Whether [redacted]'s current liquidating value was negative in [redacted]?

b. Whether [redacted]'s reasonable potential value was hopeless in [redacted]?

2. Whether the transfer of the assets of [redacted] to [redacted] is one of a series of distributions in complete liquidation within the meaning of I.R.C. § 332?

3. Whether the transfer of [redacted]'s assets to [redacted] gives rise to income under I.R.C. § 367(b)?

4. Whether the Taxpayer has substantiated its basis in [redacted]?

Short Answer

Worthless stock deduction

Based on the information we have at this time, the Taxpayer has not adequately substantiated the worthless stock deduction. Too many questions remain about the worth of [redacted]. We know it was losing money in its operations, primarily in its dealings with related parties. However, the Taxpayer continued [redacted]'s operations after shutting [redacted] down. But, continuing the business operations does not automatically jeopardize the worthless stock deduction. [redacted](b)(5)(AC)[redacted]. Nevertheless, it is reasonable to deny the deduction. Further factual development will be necessary. [redacted](b)(5)(AC)[redacted].

Liquidation

The [redacted] transfer of [redacted]'s assets to the foreign branch of a United States corporation appears to be the first and only distribution in complete liquidation under § 332. The plan of liquidation was adopted in [redacted], according to the Taxpayer's correspondence. If [redacted] was solvent, no loss may be taken. If [redacted] was insolvent, a loss under either section 165 or 166 may be taken. Again, the same question discussed above, valuation, is raised.

§ 367(b)

The inbound liquidation of [redacted] in [redacted] gives rise to the possible application of § 367(b). The tax effects might be substantial because [redacted] had the right to use the [redacted] trademark and logo. At this point, the effects of § 367(b) cannot be conclusively determined because the facts have not been developed. Due to time constraints, it may be impossible to develop all of the facts on the application of § 367. This memorandum does not express an opinion on § 367. If it is possible to develop the facts before the statute expires, let me know.

Basis in stock

The Taxpayer's calculation of basis in the [redacted] stock raises a number of questions, which have not been addressed. [redacted] owned one-half of [redacted]'s predecessor, but supposedly purchased the half it already owned. Their rationale for not using a carryover basis is not known. Including this purchase price in basis requires further explanation. The explanation for a $[redacted] equity investment shortly before liquidating the company is inconsistent with the facts because [redacted] did not have debts of $[redacted]. Lastly, an inter-company debt does not give rise to basis. (b)(5)(AC) [redacted].

Summary of Facts

In summary, [redacted] was a petroleum products marketing company doing business in [redacted]. A United States subsidiary of the Taxpayer indirectly owned it. [redacted] was losing money in its dealing with (i) its subsidiary, [redacted] and (ii) [redacted], an [redacted] subsidiary of the taxpayer. In [redacted], [redacted] had taken steps to cease dealings with these subsidiaries, however significant losses had already taken place by the end of [redacted]. The losses resulted in [redacted]'s failure to maintain [redacted]'s minimum capital requirements.

The Taxpayer decided in [redacted] or early [redacted] to transfer the assets and liabilities of [redacted] to another subsidiary, which presumably had sufficient capital. All of [redacted]'s employees, contracts, and operations were transferred to [redacted] in mid-[redacted]. Assets were transferred at book value. No losses or gains were recognized on the transfers. Liabilities exceeded the assets' total book value. This difference was booked by [redacted] as a loan from [redacted], the "buyer" of [redacted]'s assets and liabilities. As part of the transfer, the number of [redacted]'s shares held by its parent were reduced in order to meet [redacted]'s minimum capital requirements.

The next year, in the latter part of [redacted], [redacted] was liquidated. The "loan," representing the excess of liabilities over book value of [redacted]'s assets, was forgiven. For [redacted] tax purposes this event was treated as producing income. It was not treated as income for U.S. tax purposes. Instead, the taxpayer added the excess to its basis in [redacted]'s stock.

Facts in Detail

The facts, in chronological order, follow:

Chronological History

[redacted] and [redacted] sign a Statement of Intent and Policy Objectives for a Joint Marketing Venture.

[redacted], a joint venture, is formed by [redacted], an unrelated third party, and [redacted], a controlled foreign corporation of the Taxpayer. [redacted] is a subsidiary of [redacted], a Nevada corporation. [redacted] is the predecessor to [redacted].

In paragraph [redacted] of the [redacted] stockholders agreement, [redacted] agrees not to directly sell its [redacted] branded [redacted] and [redacted] products in [redacted], except through [redacted].

Per [redacted]'s valuation dated [redacted], [redacted] had "exclusive use of [redacted] trademarks in [redacted] without royalty, under the terms of a shareholder agreement dated [redacted]." This is the license agreement dated [redacted].

Joint Venture terminated. [redacted] and [redacted] state that they will enter into a "Share Purchase Agreement". The response to IDR [redacted] indicates two purchases for the same amount:

Purchase price of [redacted]% [redacted] from [redacted]
Purchase price of [redacted]% [redacted] from [redacted]

[redacted], at the time of writing this memorandum, has not been identified.

Apparently [redacted] was renamed [redacted] and after [redacted] was [redacted]% owned by [redacted]. Since [redacted]'s business was limited to distributing [redacted] products and

was the exclusive distributor in [redacted].

[redacted] owns [redacted] shares of [redacted] common stock per Form 5471 ([redacted] is the same Nevada corporation that owned [redacted]'s predecessor.)

[redacted], an employee of the [redacted] tax department, sent an e-mail message regarding the [redacted] appraisal that [redacted] of [redacted] had undertaken. She states that he, [redacted], cannot think of any relevant intangible assets in [redacted] and that the maximum value of [redacted] is its net worth. She also stated that the appraisal date will be [redacted] using [redacted] unaudited financials. Contrary to [redacted]'s message, [redacted] did not use a [redacted] appraisal date and did discuss intangible assets, the exclusive distribution agreement and license that [redacted]'s predecessor was granted. He understood that [redacted] took over the same agreements, but he did not attempt to value them. [redacted] was apparently unaware of the "going concern" intangibles, such as outstanding contracts, licenses, permits, labor relationships, etc. actually transferred to [redacted]. Going concern intangibles were ignored by [redacted].

Fax to [redacted] at [redacted] from [redacted], [redacted]: "Last week we held a meeting with [redacted]. As a result of it, they ask us to confirm you [sic] that it's necessary to contribute the funds of [redacted] of [redacted] to restore the Company's net worth prior its [sic] liquidation. This contribution would be made before the end of our audit work on [redacted]."

Valuation report from [redacted] of [redacted] to [redacted] for attention of [redacted]. This is in response to [redacted]'s request to value the shares of the Company as of [redacted] for tax purposes. The worthless stock deduction was taken in [redacted], not [redacted].

[redacted] states, "You have informed us of the plan by the Group to transfer the business and operational assets of [redacted] (the Company) to the [redacted] branch of [redacted] (the [redacted] Branch) in [redacted], and of the plan to subsequently liquidate the Company."

[redacted] explains that [redacted] is undercapitalized under [redacted] law and would require an injection of funds. "The potential value of the business of the Company is significantly conditioned on the terms of an exclusive distribution agreement signed by the Company", which is nonassignable. (p. 4).

He concludes that the shares are worthless as of [redacted] "in the present situation." He did not define his use of "value" in the report.

[redacted]

Letter from [redacted] at [redacted] states "[redacted] a wholly owned U.S. subsidiary of [redacted], will acquire all assets and liabilities of [redacted] for their fair market value, **up to a break-even point** as part of a restructuring effort during [redacted]. To compensate [redacted] for the losses it has incurred, [redacted] will fund [redacted] to the extent required under [redacted] law." (emphasis added). ([redacted] was subsequently renamed [redacted].)

[redacted]

Draft "Agreement for the Transfer of Assets and Liabilities" translated into English states that "[redacted] is interested in acquiring and [redacted] is interested in transferring [redacted]'s going concern as of the date of this Agreement ... including all assets and liabilities owned by [redacted] as of the date of this Agreement." And, "[redacted] is furthermore interested in inheriting and [redacted] is interested in transferring the contractual position of [redacted] in all

contracts, warranties, responsibilities, licenses, permits, labor relationships and any other legal or factual relationship to which [redacted] is a party, beneficiary, obligor, or owner, as well as all rights, capacities, charges and obligations which correspond to [redacted] by virtue of the said contracts, warranties, responsibilities, licenses, permits and relationships. (emphasis added).

[redacted]

Date of change from [redacted] holding [redacted] shares to [redacted] shares of common stock, per Sch. B in [redacted] tax package, which states, "[redacted] was a [redacted] products marketing company. [redacted]'s only physical address was a sales office at [redacted]. The assets at this location were transferred to [redacted]; [redacted] owned no business assets at [redacted]."

Per e-mail dated [redacted], [redacted]'s capital was reduced in order to be able to comply with the minimum capital requirements under [redacted] law.

* [redacted] is a [redacted]% owned subsidiary of [redacted], which is a [redacted]% owned subsidiary of the Taxpayer.

[redacted]

All assets and liabilities of [redacted] were transferred to [redacted] (which was subsequently re-named [redacted]. The difference between assets and liabilities transferred was [redacted]. This was booked as an intercompany payable (by [redacted]) and intercompany receivable (by [redacted]). To avoid transfer of funds, this debt was forgiven by [redacted] and [redacted] "recognized the income for [redacted] purposes only. The books of [redacted] following the asset & liability transfers reflect the intercompany payable and zero equity. For tax purposes that intercompany liability was recognized as part of the [redacted] worthless stock loss." [redacted] memo.

[redacted] Final version of Agreement for the Transfer of Assets and Liabilities. The TP provided a [redacted] version of the agreement. It appears to be similar to the draft, but this version contains the attachments (in Spanish).

The business reason for the sale of [redacted]'s assets was to obviate the need for another capital contribution into [redacted]. [redacted]'s liabilities exceeded its assets, putting it in a negative equity. [redacted] law prohibited negative equity. Transferring [redacted]'s operations to [redacted], reducing the number of shares, and "creating" the "intercompany payable" increased [redacted]'s equity to the legal minimum.

[redacted] Sale price of [redacted]'s assets was [redacted] plus the assumption of liabilities by the buyer, [redacted]. TP states, "[redacted]'s assets and liabilities were transferred to [redacted] at a fair value equaling book value." ([redacted] memo from TP).

No valuation of [redacted]'s assets were prepared. No other valuation of the investment in [redacted] was done other than the valuation prepared as of [redacted]. According to the Taxpayer, no significant changes occurred in the financial condition of [redacted] in the first half of [redacted], other than the [redacted] contribution to capital, took place. The taxpayer's position is that the asset sale to [redacted] fixes the worthlessness of [redacted]. After the sale [redacted] had no assets and conducted no business activity.

[redacted] [redacted] (formerly [redacted] signed the current lease for the office location at [redacted]. [redacted] had previously leased this space.

[redacted] Tax Return TP deducted $[redacted] as an item styled "loss on sale of [redacted] stock". This description is apparently an error. TP states that the loss relates to the worthlessness of [redacted]'s equity investment in

the shares of [redacted]. Any description of this same loss as 'Loss on Sale of [redacted] Stock' is inaccurate. [redacted] did not sell any of its shares of [redacted]. The worthless stock loss of $[redacted] was claimed in [redacted] and [redacted] still held [redacted]% of the equity shares of [redacted] until the liquidation of [redacted] in [redacted]. It is the outstanding equity shares of [redacted] which were determined to be worthless in [redacted]. Its inventories of raw materials, work-in-progress, finished products, etc., were not worthless. ([redacted] memo from Taxpayer)

Calculation of deduction follows:

Purchase price of [redacted]% interest from [redacted]
Purchase price of [redacted]% interest from [redacted]
Equity investment [redacted]
Intercompany Payable to [redacted]

[redacted]'s [redacted] results from operations: ($[redacted]); gross receipts: $[redacted]

end of [redacted] [redacted] owned no business assets

[redacted] Power of Attorney form signed. It grants certain named [redacted] officers and others the power to change [redacted]'s name, take any steps referring to "dissolution and liquidation of [redacted], and in particular (i) declaration of dissolution and liquidation (ii) appointment of liquidators."

[redacted] Letter from [redacted] to [redacted]: "[redacted], the parent of [redacted] is in the process of liquidation of this wholly owned subsidiary. The subsidiary owes the parent approximately [redacted] resulting from past advance of funds. [redacted] intends to forgive the claim in order to allow the liquidation process to be completed."

[redacted] [redacted]'s name was changed to [redacted] Per TP, the "reason

behind the name change was that it was not desirable to liquidate a company with '[redacted]' in its name..." ([redacted]

[redacted] was liquidated

[redacted] Tax Return [redacted] owned [redacted] shares of [redacted] at beginning and end of year per [redacted] Form 5471

[redacted]'s net income: $[redacted] in [redacted]

Current earnings and profits is [redacted] and net subtractions total [redacted] per Form 5471. E&P balance at the end of the year is -[redacted] per "5471"

[redacted] reported no sales for [redacted] per 5471

The [redacted] tax package, in two places, describes the [redacted] as a loan from stockholders, "[redacted] - short term"

[redacted] was liquidated per Taxpayer. At time of liquidation, no liabilities remained; no tax basis in [redacted]'s stock; no distribution to shareholder pursuant to the liquidation and [redacted] owned [redacted]% of the stock of [redacted].

[redacted]'s business was continued by [redacted], renamed [redacted].

Affiliated Corporation

Under I.R.C. § 165(a) a taxpayer is allowed a deduction for losses sustained and not compensated for by insurance or otherwise. I.R.C. § 165(g)(1) provides that if any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. Section 165(g)(2) defines security to include a share of stock in a corporation. Treasury Regulation section 1.165-5(b) provides that if any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a)

as an ordinary loss.

Section 165(g)(3) provides that for purposes of section 165(g)(1), any security in a corporation affiliated with a domestic corporate taxpayer shall not be treated as a capital asset. For purposes of section 165(g)(1), section 165(g)(3) provides that a corporation which has issued a security is treated as affiliated with the taxpayer only if: (A) stock possessing at least 80 percent of the voting power of all classes of the issuing corporations's stock and at least 80 percent of each class of its nonvoting stock is owned directly by the taxpayer and (B) more than 90 percent of the aggregate of the issuing corporation's gross receipts for all taxable years has been from sources other than royalties, rents (excepts rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. I.R.C. § 165(g)(1) and Treas. Reg. § 1.165-5(b) provide that a deduction for worthless securities is only allowable in the year in which the stock becomes wholly worthless.

Section 1.165-5(d) provides that if a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of section 1.165-5(d)(2) and the security becomes wholly worthless during the tax year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with section 1.165-5(b). The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, because section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1).

Because [redacted] was a wholly-owned corporation, Treas. Reg. §§ 1.165(g)(3)(A) and (B) are satisfied and the loss on the stock of [redacted], if allowable pursuant to section 165, would be treated as an ordinary loss.

I.R.C. § 165(g)(3) and Treas. Reg. § 1.165-5(d)(2)(ii) are also satisfied. These sections prohibit ordinary loss deductions where otherwise affiliated companies are investment or holding companies. There is no evidence that the Taxpayer acquired [redacted] in order to convert a capital loss to an ordinary loss. Until [redacted], [redacted] was an operating company selling [redacted] products in [redacted].

Worthless Stock Deduction

Worthlessness is a factual question. The taxpayer's attitude and conduct, while relevant, are not exclusively determinative in establishing worthlessness. Instead, all pertinent facts and circumstances, objective and subjective, must be considered. Boehm v. Commissioner, 326 U.S. 287 (1945).

No deduction is allowed for the partial worthlessness of stock. Section 1.165-4(a) provides that a mere shrinkage in the value of stock, even though extensive, does not give rise to a deduction under § 165(a) if the stock has any recognizable value on the date claimed as of the date of the loss. Section 1.165-4(a) further provides that a loss due to a decline in value of stock will not be allowed as a deduction under section 165(a), except insofar as the loss is recognized upon a sale or exchange of the stock or the loss is otherwise permitted under Treas. Reg. § 1.165-5, which permits the deduction of losses for wholly worthless securities.

The courts have adopted a two pronged test for determining whether stock is worthless. Both prongs of the test must be met to claim the deduction. Stock that is worthless is devoid of any present value and potential value. Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), aff'd 112 F.2d 320 (7th Cir. 1940):

> The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through the foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has liquidating value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed the liabilities of the corporation in the future, its stock, while having no liquidating value, has potential value and can not be said to be worthless. The loss of potential value, if that exists, can be established ordinarily with satisfaction only by some 'identifiable event' in the corporation's life which puts an end to such hope and expectation.

A. Present Value

There is no present value, or liquidating value, when the liabilities (including contingent liabilities) of the company exceed the value of its assets. In making this assessment, the

assets should be "fairly appraised", Thompson v. Commissioner, 115 F.2d 661, 662 (2d Cir. 1940), and the record should contain "independent evidence" of value of the corporation's property, Shipley v. Commissioner, 17 T.C. 740, 743 (1951). As discussed below, we do not believe that the [redacted] appraisal meets those criteria.

The [redacted] appraisal, dated [redacted], concludes that both the unadjusted and adjusted values (in Pesetas) of [redacted]'s liabilities exceed its assets:

	Unadjusted	Adjusted
Liabilities	[redacted]	[redacted]
Assets	[redacted]	[redacted]
Deficit	([redacted])	([redacted])

There are a number of obvious faults with [redacted]'s appraisal. First, it is based solely on the appraiser's conversations with the general manager of [redacted] and the Taxpayer. The economic conditions of [redacted] and the marketing outlook for [redacted] products are not analyzed.

Second, the value of the assets are based on book values, with certain adjustments made to some assets. Book values are historic costs of assets less depreciation. Book values do not necessarily represent fair market values. The adjustments made by the appraiser did not attempt to reflect a current appraisal of the corporation's assets. Instead, the adjustments either increase operating losses ([redacted] and [redacted]) or transform an operating profit into an operating loss ([redacted]). The explanations are sparse, such as audit qualification for taking profit on sales before delivery is made.[1]

Third, many of [redacted]'s write offs in [redacted], which transform a profit into a loss, are for debts incurred on sales made to either its own subsidiary ([redacted]) or another [redacted] subsidiary ([redacted]). Given the potential for lack of arm's length dealings, these write offs should be subject to very close scrutiny. The appraiser did not make any such scrutiny.

---

[1] This adjustment seems to change [redacted]'s method of accounting from the accrual method to the cash method. Because [redacted] had inventories, this would appear to be an incorrect change if it were being made for tax purposes. The appraiser did not explain why it should be made for valuation purposes.

Fourth, no attempt was made to value [redacted]'s assets at amounts that could be realized in a sale to an unrelated third party. In fact, two potentially significant assets were not even valued - sales delivery contracts and [redacted]'s exclusive use of [redacted] trademarks in [redacted] without royalty. [redacted]'s assets included inventories of raw materials, work-in-progress, finished products, which the taxpayer agrees were not worthless.

Fifth, the appraiser concludes that the shares of [redacted] are worthless as of [redacted]. While not entirely clear, it is possible that the Taxpayer ignored this appraisal because it took the worthless stock deduction the following year. Furthermore, the [redacted] tax return filed by the Taxpayer contains the description, "Loss on sale of [redacted] Stock" for the deduction of $[redacted]. On audit, the Taxpayer contends that this description is incorrect.

Lastly, not all of [redacted]'s assets are valued. Omitted are the going-concern assets, such as goodwill, going-concern value and right to use the [redacted] trade-mark. The significance of this omission is substantial. Goodwill is normally valued by reference to the earnings history and capacity of the business out of which it grows. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 10.03[2] n. 36 (5th ed. 1987). Going-concern value is the increase in the value of assets due to their existence as an integral part of an ongoing business. Concord Control, Inc. v. Commissioner, 78 T.C. 742 (1982), acq. 1984-2 C.B. 1 (1984). The Taxpayer's appraisal does not analyze the capacity of [redacted]'s business. Nor does it even acknowledge the existence of any going-concern value, despite the fact that [redacted] was clearly going to acquire [redacted] as a going concern. The appraiser did not apply the willing buyer willing seller standard in valuing [redacted].

In summary, the [redacted] appraisal provides little substantiation that the present or even potential value of the Taxpayer's investment in [redacted] was worthless in [redacted] the year in which the deduction was taken. Even if it were relevant to [redacted], the omissions and flaws in the appraisal limit its usefulness as a substantiation. [redacted] was not "fairly appraised," the values are not based on "independent evidence" because the appraiser relied on unaudited balance sheet and income statements for the year ended [redacted], and no valuation was prepared for the year in which the worthless stock deduction was taken.

The Taxpayer's correspondence indicates that [redacted] management took steps to transfer [redacted]'s potential future value to another subsidiary without reference to fair market

value of [redacted]'s assets. In a letter dated [redacted], [redacted] of [redacted] states: "[redacted], a wholly U.S. subsidiary of [redacted] will acquire all assets and liabilities of [redacted] for their fair market value, up to a break-even point as part of a restructuring effort during [redacted]." [redacted] letter, emphasis added). In other words, the purchase price was capped at the break-even point - that is the difference between assets and liabilities. Break-even point is certainly not fair market value.

The Taxpayer has not provided an appraisal as of [redacted], but could do so at any time. Following the transfer of its assets and liabilities on [redacted], an appraisal might value [redacted] with a zero present value. In the event the Taxpayer argues that [redacted]'s post-[redacted] present value is zero, the Commissioner's position should consist of two parts. First, the [redacted] transfer of [redacted]'s business operation produces an I.R.C. § 301 distribution to the extent that the fair market value of property transferred to [redacted] exceeds basis. Second, the Taxpayer liquidated [redacted] on [redacted]. Unless the Taxpayer can demonstrate that [redacted] was insolvent on that day, no gain or loss is recognized on the liquidation. I.R.C. § 332. The tax effects of § 332 are discussed below.

B. Potential Value

Potential value is that value to be derived through foreseeable future operations. The loss of potential value is generally established with an identifiable event in the corporation's life that puts an end to any hope that its assets will exceed its liabilities. For example, in The Austin Co., Inc. v. Commissioner, 71 T.C. 955 (1979), the taxpayer's Mexican subsidiary had entered into a binding commitment to sell its assets, ceased operations, was winding up its affairs. The Court found that an identifiable event had taken place.

An identifiable event includes the sale of property. United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 401 (1927); Poesel v. Commissioner, 77 T.C. 992, 1005 (1981).

In short, there is no potential value when the facts and circumstances indicate that there is no possibility for the shareholders to receive a return on their investment. After the [redacted] transfer of [redacted]'s assets and liabilities to the [redacted] branch of a [redacted] subsidiary, [redacted] no longer has any business assets.

Despite the appearance of a lack of potential return, as of

[redacted], from [redacted]'s operations, the Taxpayer did not terminate [redacted]'s business. The Taxpayer continued [redacted]'s business in another form, namely in a [redacted] branch ([redacted] of another subsidiary belonging to the Taxpayer.[2] Under these circumstances, the Commissioner should closely examine the events giving rise to the Taxpayer's claim of worthlessness.

[redacted] transfer of [redacted]'s assets & § 332

As discussed below, [redacted] was probably liquidated on [redacted]. Liquidation of an **insolvent** subsidiary is not subject to the no-gain, no-loss recognition rules under § 332. Whether [redacted] was insolvent is an open question due to the flawed [redacted] appraisal for [redacted] and lack of any appraisal for [redacted]. (b)(5)(AC) [redacted].

Initially, it appears that [redacted] was liquidated at the time all of its assets were transferred to [redacted]. Liquidations of corporate subsidiaries are governed by I.R.C. § 332. Section 332 provides that no gain or loss shall be recognized on a corporation's receipt of a distribution in complete liquidation of another corporation if (1) the corporation receiving the property owns at least 80% of the distributing corporation's stock, (2) the distribution is in complete redemption of all of the distributing corporation's stock, and (3) the liquidation is completed within specified time limits.

[redacted] was [redacted]% owned by [redacted] and therefore meets the control requirement, ¶ (1), above. On [redacted], [redacted]'s stock was canceled, meeting ¶ (2), above. Whether the liquidation was completed within the requisite time limits is discussed below.

A liquidation must be done in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within 3 years from the close of the taxable year during which is made the first of the series of distributions under the plan. When did the Taxpayer adopt the plan of liquidation? Reviewing the significant dates, shows a number of possible dates: On [redacted], [redacted]

---

[2] Continuation of [redacted]'s business by the Taxpayer does not automatically jeopardize the parent corporation's bad debt deduction or worthless stock deduction. Rev. Rule 70-489, 1970-2 C.B. 53, amplifying Rev. Rul 59-296, 1959-2 C.B. 87; PLR 8801028; PLR 9610030.

[redacted] reduced its number of shares from [redacted] to [redacted]. In [redacted], a meeting was held in which steps to liquidate [redacted] were formulated. On [redacted], all of [redacted]'s assets and liabilities were transferred to [redacted]. On [redacted], [redacted]'s name was changed to [redacted]. On [redacted], [redacted] was liquidated.

The Taxpayer will contend the plan of liquidation was adopted on [redacted], the date of the formal resolution. However, there is another, more likely, date of adoption of a plan. [redacted]'s e-mail message of [redacted] refers to a meeting in which the plan to liquidate [redacted] was set. It states:

> Last week we had a meeting with [redacted] As a result of it, they ask us to confirm you [sic] that it's necessary to contribute the funds of [redacted] of [redacted] to restore the Company's net worth prior to its liquidation. This contributions [sic] would be made before the end of our audit work on [redacted]. [sic] Best regards

Shortly thereafter, [redacted] of [redacted] prepared a valuation report, dated [redacted], which reports a similar plan. It states:

> You have informed us of the plan by the Group to transfer the business and operational assets of [redacted] (the Company) to the [redacted] branch of [redacted] (the [redacted] Branch) in [redacted], and of the plan to subsequently liquidate the Company.

The [redacted] meeting is the most obvious date for adoption of a plan of liquidation. A formal plan, like the one made on [redacted], is not required under § 332. Burnside Veneer Co. v. Commissioner, 167 F.2d 214 (6th Cir. 1948), aff'g 8 T.C. 442 (1947). At issue in Burnside is whether a plan of liquidation existed. The Sixth Circuit agreed with the Tax Court that a plan is a method of putting into effect an intention or proposal. "The statute does not require a formal plan. Here the proposal was the liquidation, and the method proposed of effecting the liquidation was the plan." 167 F.2d at 217. As a practical matter, the liquidation of [redacted] was accomplished in [redacted], the same year as the adoption of the informal plan of liquidation.

The Fifth Circuit also takes a practical approach to finding a plan of liquidation. In Kennemer v. Commissioner, 96 F.2d 177,

178 (5th Cir. 1938), aff'g 35 B.T.A. 415 (1937), the court said: "It is not material * * * that no formal resolution to liquidate or dissolve the corporation had been adopted when the distribution was made. An intention to liquidate was fairly implied from the sale of all the assets and the act of distributing the cash to the stockholders * * The determining element was the intention to liquidate the business, coupled with the actual distribution of the cash to the stock holders."

Unlike the facts in Kennemer, the taxpayer's intention to liquidate need not be implied here. That intention was reported by [redacted] and the transfer of [redacted]'s "going concern" and all of its assets and liabilities to [redacted] simply confirms the intention to liquidate.

Under § 331, the Fifth Circuit reiterated its Kennemer holding in Genecov v. United States, 412 F.2d 556, 561-562 (5th Cir. 1969), where it concluded that a transfer of property to shareholders constitutes a distribution in complete liquidation because it is the intent to shut down and liquidate the corporation that is controlling, not whether a plan of liquidation was formally adopted.

The facts and the law support a finding that a plan of liquidation was adopted in early-[redacted]. (b)(5)(AC) [redacted].

Satisfying the elements of I.R.C. § 332 does not automatically result in a finding of no gain or loss recognition on liquidation. There is a special rule for insolvent subsidiaries. Section 332 does not apply to insolvent subsidiaries. Instead, where the subsidiary is insolvent, the loss may be an ordinary loss under I.R.C. § 165(g)(3). Treas. Reg. § 1.332-2(b). A financial analysis should also be done to determine whether [redacted] was solvent or insolvent on [redacted].

Possible application to I.R.C. § 367(b)

While numerous questions remain as to whether the Taxpayer has adequately established insolvency,[3] there is another Code section that might apply. [redacted] is a foreign corporation controlled by a United States corporation and is being liquidated

[3] See the "Present Value" section of this memorandum.

under § 332 into a United States corporation [redacted] percent owned by its United States parent. It appears that I.R.C. § 367(b) applies. The foreign subsidiary is treated as a corporation only if the parent corporation includes in its income and pays tax on the "all earnings and profits amount"[4] attributable to its stock in the foreign subsidiary.

Under Temp. Reg. § 7.367(b)-1(c)(1), the Taxpayer should have filed a notice setting forth the details of the exchange. We will need to find out if this notice was filed. In the event that the Taxpayer did not comply with I.R.C. § 367 and the regulations, the Service has the option of treating [redacted] as something other than a corporation. On liquidation, [redacted] is transferring its right to use the [redacted] trademark back to a United States corporation, there is a potential for high recognition of gain under section 367. (b)(5)(AC) [redacted].

Basis of [redacted] stock

The Taxpayer calculates its basis as follows:

Purchase price of [redacted]% interest from [redacted]	$ [redacted]
Purchase price of [redacted]% interest from [redacted]	
Equity investment [redacted]	
Intercompany Payable to [redacted]	
	$ [redacted]

The "purchase" from [redacted] has not been explained. [redacted] and [redacted] owned [redacted]'s predecessor. Why over $[redacted] was paid to [redacted] is unexplained. What [redacted] stands for is also not explained.

Another question that arises is the [redacted] contribution to capital. According to the Taxpayer, it was needed to pay third party creditors. However, at the end of [redacted], [redacted]'s liabilities were nowhere near $[redacted]. As a precaution, unless these items can be satisfactorily and clearly explained, I recommend that we challenge the Taxpayer's basis also.

---

[4] "All earnings and profit amount" means the earnings and profits or deficit for all tax years which are attributable to the stock of the foreign corporation exchanged under § 1248 and the regulations. It does not include earnings or deficits of any lower-tier corporations.

Lastly, the intercompany payable, $[redacted], by its nature, cannot increase basis of stock. Lewellyn v. Electric Reduction Co., 275 U.S. 243, 246 (1926). Even if it could, the assets, the value of which are directly related to the $[redacted] payable, were not valued.

In [redacted], the Taxpayer reduced its shares in [redacted] from [redacted] to [redacted]. This action does not produce a loss or increase or decrease total basis. Instead, the existing basis is spread over fewer number of shares. Commissioner v. Fink, 483 U.S. 89, 107 S.Ct. 2729 (1987).

Please do not hesitate to call if you have any questions. My direct dial number is (281) 721-7311.

By: /s/ Lillian D. [illegible]
LILLIAN D. BRIGMAN
Special Litigation
Assistant